No. 22671

In the

United States Court of Appeals

For the Ninth Circuit

Robert E. McDonough, *et al.*,

Appellants,

vs.

Snelling & Snelling, Inc.,

Respondent.

On Appeal from the United States District Court
for the Central District of California

RESPONDENT'S BRIEF

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RESPONDENT'S BRIEF

JURISDICTION

This action was brought by Snelling & Snelling, Inc., a Pennsylvania corporation, against Appellants and other Defendants, all citizens and residents of the State of California, for injunctive and declaratory relief and for damages in excess of $10,000.00. The District Court's jurisdiction was therefore invoked under 28 U.S.C.A. §1332 (a)(1). Appellants make this interlocutory appeal pur-

suant to the provisions of 28 U.S.C.A. §1292 (a)(1) from a preliminary injunction entered on November 21, 1967.

STATEMENT

The Snelling System

Respondent is the successor to a partnership founded in 1951 by Louis R. Snelling, Jr., and his wife, Gwendolyn, to operate a single personnel agency in Philadelphia, Pennsylvania (Pl. Ex. 1, *Operational Manual — Manager's Operation,* hereinafter "MM", at 19). Today, Respondent still operates a personnel agency in Philadelphia, but has some two hundred seventy-five franchisees operating over three hundred twenty-five offices throughout the United States (II R. 255: 10-23).

A new Snelling franchisee receives training at Respondent's headquarters in Pennsylvania and three basic manuals which contain information and guidelines regarding the "Snelling system" for operation of a personnel agency — information and guidelines which Respondent has developed since 1951 and revises from time to time (II R. 88:3-89:18; 212:12-213:5; MM:II). The three manuals are designed to guide counselors, receptionists, and the franchisee-manager. In the Manager's Manual, the franchisee is given detailed instructions regarding the establishment, staffing and operation of an agency, with particular emphasis on: 1) techniques which will enable counselors to place all *qualified* applicants instead of filling only existing "job orders": and, 2) a detailed, analytical system of record keeping and reports which will enable both the franchisee-manager and Respondent to detect strengths and weaknesses in his business (MM: 172-176; 219-251; II R. 95:19-96:15).

Respondent assists the franchisee in selecting a location within his franchised area (MM: 54-61). After he has selected a location and hired an initial group of counselors, one of Respondent's "National Supervisors" trains the

counselors in non-managerial aspects of the Snelling system (II R. 88:22-89:13). Thereafter, National Supervisors continue to guide the progress of each office through periodic visits (II R. 105:25-107:9; 170:25-171:14).

Each franchisee is required to make detailed monthly reports to Respondent in Pennsylvania (MM: 241-250). From these, the Pennsylvania office attempts to detect, analyze, and — hopefully — solve problems in the reporting office and problems which are common throughout the system (MM 241-244; II R: 163:8-168:3).

In order to provide training in new techniques and solve problems pointed out in franchisees' reports, Respondent conducts periodic "regional seminars" in various parts of the country. Such seminars have been held in California during the past four years, each dealing with solutions to specific problems which have been developed by Respondent's head office in Pennsylvania (II R. 163:8-168:3). Separate regional conferences are also held to train or retrain counselors (II R. 169:8-170:24).

Franchisees receive advertising material prepared by Respondent (MM: 83, 153-156) and the benefit of Respondent's national advertising (II R. 30:18-24; 264:14-266:14). Although limitations which California law places upon an employment agency's use of a franchisor's name (II R. 259:13-260:18) lessen the effectiveness of advertising (II R. 237:16-238:7), there is no evidence to indicate that it lacks substantial value.

The Snelling system has had its share of growing pains and has not been uniformly successful. During the years that it grew from a single agency to a nationwide organization, Snelling & Snelling suffered some attrition. (II R. 255:6-256:6). Of roughly five hundred businessmen who have held franchises, perhaps fifteen percent have left the business because they were unsuccessful (II R. 230:1-24).

Respondent has also been troubled by demands of some very successful franchisees who have come to resent the

contractual requirement that they pay seven percent of their gross receipts to the head office in Pennsylvania (II R. 172:11-173:8). Snelling's Vice President, who had just returned from addressing a meeting of the International Franchise Association, testified that many successful franchisors face the same problem (II R. 171:19 173:8). In Snelling's case, some franchisees have banded together to form the Franchise Owners' Association (II R. 179:10-16; 238:20-246:11), while some have made concerted attempts to renegotiate their agreements with Snelling (II R. 247:21-249:11). Prominent among the rebels is Appellant, Robert E. McDonough.

Appellants' Association with Snelling & Snelling

Robert E. McDonough was an experienced businessman prior to his affiliation with Respondent, having served as vice president in charge of sales for a regional oil company which had outlets in seven Southern states (II R. 7:18-8:1; 50:7-51:4). When he became interested in purchasing a Snelling franchise in early 1965, McDonough acted in a businesslike fashion and had the franchise agreement reviewed by his attorney in Mobile, Alabama (II R. 8:11-8:20). Apparently finding no objection to the terms of that agreement, he attended Respondent's training course in Pennsylvania for two weeks and executed a contract to purchase the Riverside franchise (II R. 8:21-9:8; 168:6-8; I R. 87-92).*

On April 15, 1965, McDonough opened his office in Riverside as the "S & S Agency", which he identified in its advertising as "a member of Snelling & Snelling" (II R. 27:24- 28:1; 37:24-38:6). Because of a ruling of the California Labor Commissioner which granted earlier franchisees a preemptive right to use Snelling & Snelling in their firm name, he adopted the "S & S" designation (II R. 19:11-23; 258:21-260:18). In doing so, he complied with

*The "Riverside franchise" did not prohibit McDonough from soliciting business outside of that city so long as his office remained there. Far from giving its franchisees "closed territories," Snelling encouraged advertising outside of the franchised city so long as a single base of operations was maintained (II R. 30:6-17).

paragraph 1(c) of the license agreement which provides that the "Licensee shall use only the name Snelling & Snelling and Licensee shall identify himself as a member of the Snelling and Snelling system, *unless state law requires other or additional identification.*" (I R. 87).

During the year 1965, gross receipts from the new Riverside agency averaged \$5,000.00 per month (II R. 22:4-20; Pl. Ex. 2). Of this amount, at least 15%-18%, or \$750.00-\$900.00 per month, represented net profit after payment of expenses (II R. 13:4-18). Throughout this period, McDonough rendered regular monthly reports and paid 7% of his gross receipts to Respondent in Pennsylvania (II R. 22:4-20; Pl. Ex. 2). He sought to promote the Snelling name and identified "S & S" as a member of the Snelling system in both his newspaper advertising and his personal contacts with employers and job applicants (II R. 35:7-38:6).

No one disputes the fact that McDonough's business prospered, so that he could report taxable income of \$16,000-\$17,000 for 1966, his first full year of operations (II R. 11:19-12:18). Admittedly, this income was somewhat higher than it might otherwise have been because he ceased paying Respondent monthly overrides in January of 1966 (I R. 27-29).

Despite the fact that he had ceased to pay overrides in January of 1966, McDonough continued to identify his agency as a member of Snelling & Snelling in Riverside advertising until May of 1967 (II R. 37:7-38:1). He also continued to attend regional meetings held by Respondent (II R. 168:9-169:7).

The first open break between Appellants and Snelling occurred on May 10, 1967, when Snelling's Assistant Secretary, Lawrence T. Knier, served notice that his franchise would be cancelled unless past due overrides were paid (I. R. 26). In response, Appellants, acting through their counsel, "rescinded" their agreement on May 19, saying, in part:

"It is obvious that in California at least, your corporation is not in a position to offer the same valuable consideration to licensees that it can in some other states. Under these circumstances, it would seem logical that a substantially reduced franchise fee and substantially reduced override percentage should govern your License Agreements in California as contrasted with such other states. Our clients would not be adverse to negotiating such a License Agreement with your corporation which would incorporate a fair and reasonable fixed license fee and fair and reasonable percentage of income payment. Neither of the payment provisions of the present License Agreement are fair and reasonable in view of your inability to deliver that which you are committed to deliver to the licensees under the written agreement." (I R. 57).

The "recission" letter of May 19 was the first round in a series of negotiations which are described in McDonough's counsel's reply to Snelling's final termination letter, which said, in part:

"August 2, 1967

Voegelin, Barton, Harris & Callister
Attorneys at Law
606 South Olive Street
Los Angeles, California 90014

Re: McDonough v. Snelling & Snelling

Your File No. 5846

Gentlemen:

We have for reply your letter of July 21, 1967, addressed to Mr. Robert E. McDonough. We presume your reference in the address to Snelling & Snelling is an oversight since, as we understand you represent Snelling & Snelling in California, you are surely aware

that none of the franchisees have ever been able to operate under that name in California.

You further suggest in your letter that Mr. McDonough failed to respond to the letter of your client dated May 10, 1967. Perhaps your client has failed to keep you informed of developments since that date. Under date of May 19, 1967, on behalf of Mr. and Mrs. McDonough we addressed a Notice of Recission to your client which was received by it on May 23, 1967. A copy is enclosed for your information and file.

Thereafter, we have engaged in five or six long disstance telephone calls with Mr. Paul Welsh of the Philadelphia law firm representing Snelling & Snelling. Our discussions have centered upon the possibilities of finding a mutually satisfactory area within which the parties could continue their contractual relationship on a substantially modified basis. The last such telephone call was on July 11, 1967, from Mr. Welsh . . . .

We feel the salutary provisions of Business and Profession's Code Sections 16600-16602, invalidating contracts in restraint of trade, protect our clients from the provisions of the contract stating that their operation of an employment agency business in Riverside, California, can be enjoined, and that these protective statutes extend to the contractual provisions incident thereto, such as the turning over of books and records, the turn over of lessee's premises and telephone number, etc. . . .

As set forth in that letter, we feel that Mr. and Mrs. McDonough were defrauded by Snelling & Snelling, Inc. in that many of these unfavorable aspects of the franchises as they pertain to the State of California were not made known to the McDonoughs when the franchise was purchased. Similarly, the inability of Snelling & Snelling to deliver these things of value

has resulted in at least a partial failure of consideration for the sums of money agreed to be paid by the McDonoughs under the license agreement. It is our opinion that the relief the McDonoughs can anticipate would be twofold: First, a reduction fee and the percentage override because of the partial failure of consideration; and, Second, the obtaining of punitive damages against Snelling & Snelling, Inc. for the fraudulent concealment of the true situation in California.

Nevertheless, the McDonoughs are reasonable people, would prefer to avoid litigation, and will meet Snelling & Snelling, Inc. half way in an effort to arrive at a reasonable disposition of this problem. We are authorized to advance on their behalf the following settlement offer:

1. The license agreement be considered terminated or rescinded and each party will release the other from any and all claims arising therefrom;

2. The McDonoughs will furnish an audited report of their gross business;

3. Snelling & Snelling, Inc. would credit back to the McDonoughs one-half of the $8,400.00 franchise fee paid;

4. The McDonoughs would be debited with a 3½ percent of their gross receipts from the commencement of their business through May 19, 1967, less any amounts previously paid;

5. McDonoughs will return to Snelling & Snelling, Inc. the training or operational manuals furnished and will agree to provide copies of those business records in their possession that Snelling & Snelling desire;

6. The McDonoughs would continue to operate at the same location and using the same telephone number and Snelling & Snelling would be free to sell the Riverside franchise to any new purchaser if desired.

We will appreciate receiving any comments or response from you or your clients to this offer at your early convenience.

Very truly yours,

HENNIGAN & BUTTERWICK

By J. D. Butterwick" (I R. 60-62).

No mention was made of a San Bernardino office which would compete with Snelling's existing franchisees.

After the breakdown of settlement negotiations, Respondent filed a Complaint against Appellants for recission, injunctive and declaratory relief and damages (I R. 2-11). Before that Complaint had been served, Robert E. McDonough advised Anne Van Tilburg, owner and operator of the Van Agency, Snelling's franchisee in San Bernardino, that he planned to open an "S & S" agency in San Bernardino (I R. 30). McDonough's own testimony indicates that he had been training counselors for a San Bernardino office for three or four months (II R. 41:15-25; 282:15-285:1) — or during much of the period when settlement discussions were in progress.

Upon being advised of his intentions, Respondent filed a First Amended Complaint and Ex Parte Application for Order to Show Cause Re: Preliminary Injunction and Ex Parte Application for Temporary Restraining Order (I R. 12-A-34). An Order to Show Cause and Temporary Restraining Order was entered on September 20, 1967, and served on September 21, restraining Respondents "from opening an employment agency office in the City of San Bernardino, or within thirty-five (35) miles of the City

of Riverside, State of California, or within thirty-five (35) miles of any other employment agency which is a duly enfranchised member of plaintiff's employment agency system'' pending disposition of the Order to Show Cause. Hearing on that Order was set for September 27, 1967 (I R. 43-45).

The Hearings Below

This Appeal arises out of hearings which were held on September 27 and 28, October 4 and 21, and November 17, 1967 and the relevant findings and orders entered by the District Court. The hearing was originally concerned with the narrow legal question of enforceability of Respondent's restrictive covenant (II R. 10:9-11:16), but was broadened to include the question of whether Snelling possesses protectable trade secrets when Appellant sought to establish that no such secrets exist (II R. 52:15-56:3: 74:20-76:23). Although the last two sessions of the hearing were nominally concerned with Appellant's Motion for Supersedeas —which was ultimately denied—the parties broadened its scope to include a re-examination of the trade secret question and the propriety of any order enjoining Appellants from operating a personnel agency in San Bernardino (e.g., II R. 147:9-160:8).

Respondent cannot agree with Appellant's assertion that there is ''little evidentiary conflict'' in this action (App. Br. 2). On the contrary, there is more than a little evidentiary conflict and there is substantial disagreement regarding interpretation of evidence in several vital areas: (1) the existence of unique, protectable business information and techniques in Snelling's initial training, manuals and management seminars; (2) the irreparable injury which Snelling would have suffered if Appellants had been allowed to operate a Riverside office: and (3) the alleged misrepresentations made to Appellant.

There is no conflict regarding the fact that Appellant had planned to open a San Bernardino office while still

carrying on negotiations with Snelling (II R. 41:15-25; 282: 15-285:1), but had barely opened his doors when the preliminary injunction was entered. September 20, 1967, was the first day when counselors occupied the San Bernardino office (II R. 14:1-16). No advertisements had been run (II R. 17:1-15) and no job applicants had come to that office by September 21 (II R. 18:6-9). A receptionist was "in training" in Riverside, but had not yet reported for work (II R. 17:16-18:5). Telephones had been installed, but numbers had not been listed with information (II R. 15:8-18).

(a) *Trade Secrets*

Testimony regarding the trade secret question was given by: (1) Robert E. McDonough; (2) Elinor Still, defendant in a companion case, which was also before the court; (3) John McBrearty, Respondent's Vice President; (4) Damon Wheeler, the Snelling franchisee in Sacramento; and, perhaps, (5) James Chadwick, owner of an agency in San Diego. Mute testimony was offered by the manuals themselves which were introduced subject to a protective order (II R. 9:9-11:18; Pl. Ex. 1).

Elinor Still, testifying for Appellants, did not deny that the Snelling manuals contain some unique business information and techniques. Instead, she stated that they contain nothing unique "other than perhaps paper work" and techniques which she, herself, disliked:

> "Q Is there anything in your opinion, from the experience you have had in the industry of unique value among those practices, procedures, policies which Snelling advocates and outlined in its manuals?
>
> "A In all honesty, other than perhaps paper work and as I commented on the practices I don't approve of, there is nothing in any one of the manuals that is any different than maybe one, or two or maybe ten agencies in Los Angeles involved themselves in for ten years." (II R. 76:13-21; see also: 74:20-76:12).

She never commented on the franchisee's initial training or information disseminated at management seminars.

Robert E. McDonough contended that the manuals contained no unique information (II R. 32:21-33:3; 53:2-55:9) and introduced other manuals which allegedly gave similar guidelines (II R. 147:9-153:19; D. Ex. B). Like Elinor Still, he noted the detailed reporting and checking procedures prescribed in the Manager's Manual (II R. 53:24-54:8).

Appellants' only other witness who touched on the subject of trade secrets was James Chadwick, owner of a personnel agency in San Diego. After having hired consultants during his first thirty days in the business (II R. 156:2-18), Chadwick later hired S. David Davis, a former National Supervisor for the Snelling system (II R. 156:19-157:4). In return for an unspecified consulting fee, travel expenses, living expenses, and a six months' override, Davis had given Chadwick and his counselors a two-week training course. Chadwick hired Davis, in part at least, because of his former association with Snelling, but did not compare his training course with the Snelling system (II R. 157:5-160:17).

An industrial engineer by training, Damon Wheeler had been a business consultant for more than twelve years before purchasing a Snelling franchise and establishing the "Sacramento Snelling & Snelling Personnel Agency" in 1964 (II R. 84:21-85:21). As a business consultant, Wheeler had worked with Snelling and many other personnel agencies, becoming generally familiar with their business practices (II R. 86:8-87:24; 90:5-93:10). Since becoming a franchisee, Wheeler had extensive contacts with other members of the system and with operators of nonaffiliated agencies (II R. 93:25-95:8). From his contacts, Wheeler was able to compare and contrast Respondent's methods of operation with those of other agencies (II R. 94:3-97:3).

In Wheeler's opinion, there is a difference between the

methods, techniques and philosophies of Snelling and those of unaffiliated agencies:

> "Q What is that difference?
>
> A Well, the difference is not only in the scope of the concept which is covered in the manual, which covers all phases of the business both from a counselor and managerial point of view, but our total approach, the philosophy is different.
>
> Q What is the difference?
>
> A Well, Snelling preaches the philosophy that "We place people; we don't fill job openings." I notice that our placements, from what I can determine in talking to my competitors, are much higher with this concept.
>
> Q How does this contrast with whatever system or technique that is used by other employment agencies in general?
>
> A Well, the usual agency that I am familiar with does what we call fill job orders. They have orders on the desk and they are trying to attract people to put into those positions. We do that, plus; in other words, we work on the basis of whoever comes into our office is placeable somewhere, and that we engage in finding those people employment opportunity." (II R. 95:19-96:15)

He believed that the Manager's Manual gave him information which he "would have had to learn the hard way, by opening an office and learning by making the mistakes you would make in opening a new business" and thought "the guidance given me in that manual in all respects permitted me to make the kind of start that we made and the future success that we have made" (II R. 98:9-15).

Wheeler earned $20,000.00 in his first year of operations, $40,000.00 in his second, and $55,000.00 in his third (II R.

97:18-22). He attributed some, if not all, of this success to the detailed guidelines laid down in the manuals:

> "I would say, however, that the detail with which these manuals are prepared really I think gave me a tremendous edge and a real start, a leg up in business so to speak. I wouldn't have known a lot of — I would have learned, I would have learned eventually how to run an office of this type, but I do feel very strongly that this information did give me a real advance, a competitive edge so to speak." (II R. 101:3-10)

In addition to receiving the manuals and their initial training, Snelling franchisees attend the annual regional seminars which John McBrearty described in some detail (II R. 163:8-168:3). Each of these seminars deals with some aspect of the personnel business which has been the subject of intensive study. McBrearty pointed out that: "it takes about a year to compile these studies, not only to make the research which you have done, but then it has to be compiled in a very meaningful manner so as to put across" (II R. 166:4-10). This information—the product of a year's research—was unquestionably received by Robert E. McDonough, who regularly attended seminars in San Francisco (II R. 168:4-169:7).

(b) *Irreparable Injury*

Instead of being confined to the more limited question of how Appellants' office in San Bernardino would affect the Van Tilburg's existing franchise (and, therefore, the revenues which Snelling derived from it), John McBrearty's testimony was largely devoted to the total impact which defiance of the restrictive covenant would have upon the Snelling organization. His opinion was not based upon direct threats or other representations which franchisees had made to him after September 20 (II R. 250:13-251:21), but upon the knowledge of their attitudes and probable behavior which he had gained as a National Supervisor and as Vice President of Snelling and Snelling (II R. 174:14-25 251:22-253:6).

At the time of McBrearty's testimony, a number of Respondent's franchisees were attempting to renegotiate their contracts (II R. 247:23-249:11) and some others, particularly in the Franchise Owners' Association, had expressed discontent with the organization (II R. 238:20-246:8; 253:7-19). Word of the San Bernardino problem had been spread through the "grapevine" (179:4-16), and it may have been mentioned in at least one Snelling publication (II R. 201:3-202:14). Furthermore, Anne Van Tilburg, the San Bernardino franchisee and party directly harmed by Appellants' action, was an active member and officer of the Franchise Owners' Association (II R. 276:16-25).

On the basis of his knowledge of the franchisees and their attitudes, McBrearty concluded that as many as fifty of them would leave the organization if Appellants were allowed to compete with the existing San Bernardino franchisee (II R. 176:8-177:3). Such a loss could cost Respondent as much as $500,000.00 per year and have a crippling effect upon the organization (II R. 177:4-178:16).

McBrearty's alleged "confusion" as to whether such loss could flow from Appellants' ultimate success after this action had been fully litigated, or from operation of an agency in San Bernardino *pendente lite* if the preliminary injunction were refused (App. Br. at 12), is more apparent than real. He was clearly concerned with the impact of any continuation of the McDonough operation in San Bernardino and believed that it would endanger Respondent's organization (II R. 181:19-184-2).

In addition to John McBrearty's testimony, the Court could take judicial notice of the fact that other Snelling franchisees were present throughout the protracted hearings (II R. 49:18-25; I R. 131). The Court also knew of ferment within the Snelling organization from a companion case arising out of a letter, circulated nationally to Snelling franchisees by Elinor Still, which discussed the California situation and urged them to breach their agreements (II R. 43:1-46:14; 72:9-18 I R. 130).

Following the McBrearty testimony, Robert E. McDonough testified that he had sought out a number of Respondent's franchises — including many of those who were renegotiating contracts — at a recent meeting of the National Employment Association, discussed the San Bernardino situation with them, and decided that they were generally indifferent to it (II R. 270:1-276:15). Thus, there is no conflict regarding the fact that it was well advertised throughout the system.

(c) *Alleged Misrepresentations*

Respondent has had a multitude of problems with the use of the name "Snelling & Snelling" by its franchisees in California. Two early franchisees claimed an exclusive right to use that name in California and eventually brought an action to prevent others from using it (II R. 69:9-71:18; see also: *William La Perch and W. J. Mills, Partners dba Snelling & Snelling v. Snelling & Snelling, Inc.*, L.A. Superior Ct. No. 863092). The California Labor Commissioner, acting pursuant to section 11803 of the Administrative Code adopted a similar position, but allowed the use of "Snelling & Snelling" preceded by a geographical designation. Thus, a franchisee such as Damon Wheeler was required to style his agency "Sacramento Snelling & Snelling" rather than "Snelling & Snelling — Sacramento" (II R. 259:13-260:2).

The rather heated dispute which ensued between the Labor Commissioner and La Perch and Mills, on the one hand, and Respondent, on the other, is evident in the *La Perch and Mills* case and can be gleaned from the testimony of Deputy Labor Commissioner Ruth M. Spiers, William La Perch, Robert A. Smith and John McBrearty (II R. 69:9-71:22; 130:10-142:4; 237:7-21; 257:9-263:15). In any event, the Labor Commissioner changed his ruling in September of 1964, forbidding use of "Snelling & Snelling" in an agency's name, but allowing the agency to advertise that it is a "member of Snelling & Snelling" (II R. 260:3 262:25), as Appellant did until May of 1967 (II R. 37:7-28:6).

The Labor Commissioner also prohibited franchisees from obtaining listings in the "white pages" of the telephone directory under the name Snelling & Snelling. However, this ruling was not made until the fall of 1965, some months after Appellants obtained their franchise (II R. 31:12-24; 263:16-264:2).

According to Robert E. McDonough's testimony, mention was made of a "California problem" when he took his training in Pennsylvania, but the "problem" was never explained, and he did not press the question when told that it had been "worked out" (II R. 56:11-58:16). He discovered the nature of the "problem" when he applied for a California license in April of 1965 (II R. 19:6-23), although his first recorded protest is the "recission" letter of May 19, 1967 (I R. 56-59).

Respondent's national advertising is admittedly less beneficial to a franchisee who can identify himself as "a member of Snelling & Snelling", but cannot use "Snelling & Snelling" as part of his firm name (237:16-238-7). However, the record below does not establish whether this fact *substantially* diminishes the value of Snelling training and a Snelling franchise.

Both McDonough and Wheeler had some correspondence with the Labor Commissioner because they followed practices which are suggested by the Manager's Manual, but do not meet with favor in California (II R. 63:25-66:9 108: 24-113:7). As the Manager's Manual notes:

> "It is virtually impossible for us to write a manual that fully advises all the members of the SNELLING AND SNELLING SYSTEM of the legal requirements in each of the scores of cities in which our system operates. For instance some cities and states have laws prohibiting certain practices of discrimination because of race, color, religious creed, ancestry, age or national origin. Others have laws specifying certain forms to be used for applications, contracts, introduc-

tion cards, receipts, invoices, etc. Still others specify certain advertising practices.

"Should any part of this manual be inconsistent or in conflict with the laws governing your operations and regulations, whether they be federal, state or municipal, then you are to disregard that part of the manual and you are instructed to strike from the manual any such inconsistency or conflict and to insert in place thereof the correct instructions." (MM:IX).

(d) *Ruling of the District Court Re: Trade Secrets, Irreparable Injury and Misrepresentations:*

On November 21, 1967, the District Court entered detailed Findings of Fact and Conclusions of Law, saying, in part:

"Plaintiff's training manuals, and the training and instructions therein given by plaintiff to each of its licensed franchisees and to the employment counselors hired by its licensed franchisees, constitute a compilation of information not available to other persons engaging in the employment agency business, which gives each of plaintiff's licensees a substantial competitive advantage over others engaged in the employment agency business. Defendants McDonough, in receiving plaintiff's manuals and training, derived such competitive advantage from plaintiff. . . . From the testimony of defendants' witnesses, it is apparent that defendants have numerous complaints about plaintiff and objections to certain aspects of plaintiff's employment agency system. The Court has no evidence before it at this time as to the extent or gravity of these complaints and objections, and cannot draw final conclusions on whether these complaints and objections are serious enough to give defendants, including defendants McDonough, legal recourse against plaintiff until after appropriate pleadings are filed raising such complaints and objections to judicial level and until there has been

a trial on the merits. But it is reasonable to conclude, based upon the evidence before the Court, that plaintiff's relations with its franchisees in the State of California are in a state of some turbulence. Further, judging from the facts set forth before the Court in the records and papers on file in the companion case, *Snelling & Snelling, Inc. v. Elinor Still, et al.*, No. 67-1381-TC, and in particular the letter of Elinor Still attached as an exhibit to plaintiff's moving papers therein, which has now been mailed nationwide to all plaintiff's franchisees, it is reasonable to conclude that this condition of some turbulence exists to some extent elsewhere in plaintiff's employment agency system outside the State of California. Finally, based upon the attendance at the hearings in this matter and in the companion case of a number of plaintiff's franchisees, of which this Court can and does take judicial notice, it is also reasonable to conclude that the present hearings and proceedings are the subject of considerable interest and attention throughout plaintiff's employment agency system. Based upon these considerations, the Court finds that unless defendants McDonough are enjoined and restrained by this Court from operating a new employment agency office in San Bernardino, California, in addition to their Riverside office, there is a substantial probability that plaintiff will be caused great and irreparable injury thereby, which no amount of money damages could ever compensate, in that other presently current franchisees in plaintiff's system will be encouraged by the example of defendants McDonough to likewise disregard their contracts, cease paying overrides, and open other or additional offices without permission from plaintiff, which is otherwise required by said license agreements. Such would tend to destroy and subvert plaintiff's employment agency system, all to plaintiff's incalculable damage; and no legal remedy would be adequate to compensate plaintiff therefor" (I R. 130-131).

(e) *Ruling of the District Court Re: the Restrictive Covenant*

The District Court also determined that a California court would apply Pennsylvania law pursuant to Paragraph 17 of the parties' license agreement and enforce the restrictive covenant found in Paragraph 8(b). In doing so, it relied upon principles which were recently articulated by California's District Court of Appeals in *Ury v. Jewelers Acceptance Corp.*, 227 Cal. App. 2d 11 (1964), and are reflected in Section 1105 of the Commercial Code (IR 134-137).

QUESTIONS PRESENTED

This appeal presents one overriding question:

Did the District Court abuse its discretion when it decided that this action presents grave and difficult questions of law and fact and a sufficient possibility of irreparable injury to justify the granting of a preliminary injunction which will preserve the *status quo* pending trial?

It also presents subordinate questions:

1) Given the fact that California's public policy against contracts in restraint of trade is subject to many judicially and legislatively created exceptions which indicate that it has no rigid, uniform policy against such contracts, would a California court enforce a restrictive covenant which is clearly valid in Pennsylvania, but possibly invalid in this state, when the parties have agreed that their contract will be interpreted and governed by the laws of Pennsylvania?

2) Do business training and business information which give their user significant advantages over his competitors constitute "trade secrets" when the user and the supplier of such training and information have agreed that they were received in confidence and will be treated as trade secrets?

3) Will a franchisor suffer "irreparable injury" justifying the granting of a preliminary injunction when a franchisee violates a restrictive covenant, appropriates the franchisor's trade secrets and then competes with him in an economically significant market area?

4) Will a franchisor suffer "irreparable injury" justifying the granting of a preliminary injunction when a franchisee's violation of a restrictive covenant and appropriation of the franchisor's trade secrets will induce other franchisees to take similar action at a cost of more than $500,000.00 per year to the franchisor?

SUMMARY OF ARGUMENT

Although both parties' briefs are concerned with some of the more complicated legal and factual questions which must be resolved at trial, the outcome of this appeal will turn on a far simpler issue: did the District Court abuse its discretion when it decided that a preliminary injunction, which would preserve the *status quo,* should be entered? If it correctly concluded that Respondent raised grave and difficult questions of law and fact and could suffer irreparable injury before trial if the injunction were not granted, then the District Court's action should be affirmed.

Two essentially factual questions were decided in Respondent's favor when the District Court concluded that Snelling & Snelling has protectable trade secrets and that it would suffer irreparable injury if Appellants were permitted to open a personnel agency in San Bernardino. Although Appellants may dispute the weight assigned to portions of the evidence presented, they cannot seriously contend that the decisions made below were unsupported by substantial evidence. Appellants might like to see this case retried in our briefs, but this Court does not sit to reweigh evidence which has already formed the basis for a reasonable decision.

The legal question regarding the validity of Respondent's restrictive covenant might have been a close one if

California's District Court of Appeals had not dealt with an identical issue some four years ago in *Ury v. Jewelers Acceptance Corp.*, 227 Cal. App. 2d 11 (1964). Principles which it formulated and articulated provide a ready answer. If this action had been brought in a California state court, the parties' choice of Pennsylvania law would have been honored and the restrictive covenant would have been enforced because: 1) the parties have chosen the law of Pennsylvania, a state having substantial "contacts" with their agreement; 2) the covenant is unquestionably valid under the law which they have chosen; and, 3) California's policy against contracts which restrain trade is not so strong as to invalidate their choice.

While Appellants' brief is liberally laced with accusations of fraud and deceit, final disposition of these charges must await a full trial on the merits. Meanwhile, they must be viewed in their proper perspective. The first cry of "fraud" rang out some *two years* after Robert E. McDonough had purchased his franchise, but just *nine days* after his franchise had been terminated for non-payment of overrides.

ARGUMENT

I. THE DISTRICT COURT CORRECTLY DETERMINED THAT APPELLANTS SHOULD BE ENJOINED FROM OPENING AN OFFICE IN SAN BERNARDINO IN VIOLATION OF A VALID RESTRICTIVE COVENANT.

A. The District Court Correctly Decided That the Restrictive Covenant Was Enforceable Under Pennsylvania Law, Which Had Been Chosen by the Parties to Govern Interpretation and Enforcement of Their Agreement.

Appellants, acting with the advice of counsel (II R. 8:11-20) freely entered into a license agreement with Respondent. Paragraph 17 of that contract contains an unambiguous choice of law clause which provides that this "agreement shall be interpreted and governed by the laws

of the Commonwealth of Pennsylvania." Those laws — which Appellant nowhere discusses — fully support the District Court's decision to enforce the restrictive covenant found in Paragraph 8(b).

Pennsylvania law governing enforcement of restrictive covenants was carefully reviewed by Justice Cohen in *Morgan's Home Equipment Corp. v. Martucci,* 390 Pa. 618 (1958). In *Morgan,* plaintiff's former employees attacked a clause in their employment contracts which provided that they would not compete with him within a radius of 100 miles for a period of one year following termination of employment. Upholding the covenant, the Court observed:

> "covenants not to compete . . . serve a useful economic function; they protect the asset known as 'goodwill' . . . indeed in many businesses it is the name, reputation for service, reliability, and trade secrets which constitute the inducement for a sale." 390 Pa. at 631.

Pennsylvania Funds Corp. v. Vogel, 399 Pa. 1 (1960), presented a factual situation closely paralleling the controversy which gave rise to this appeal. The defendant, who was employed to sell mutual funds, had agreed not to compete with plaintiff throughout the state of Pennsylvania for two years following the end of his employment. In rejecting the former salesman's contention that the contract should not be enforced, the court commented:

> "Plaintiff has expended considerable sums of money and time in creating goodwill and *in maintaining an extensive and continuous training program for its employees and salesmen* and, as a result of its policy of public relations and continuing education for its employees and salesmen in the securities field, it has become a substantial and well-established retail dealer of mutual funds in Pennsylvania. Much of the *training, literature and instruction is tailored to problems unique to the sale of mutual funds* and was

> especially prepared by Douglas K. Porteous, president of Pennsylvania Funds, who has had wide experience in the sale of securities and is *a recognized authority* in the field. . . . [T]he aforesaid activities of the defendant have caused and threaten to continue to cause irreparable damage to plaintiff's valuable goodwill, and negate the efforts and monies invested in plaintiff's employee training program." 399 Pa. at 7-8.

The Pennsylvania Supreme Court's reasoning in *Pennsylvania Funds* unquestionably applies to the present action. Snelling & Snelling has developed a national employment agency system with more than two hundred members. It has expended time and effort in training Appellants and their counsellors. The training and manuals which Respondent furnished were: (1) tailored to problems unique to employment agencies; and, (2) were specially prepared by Robert O. Snelling, Sr., who has wide experience in operating such agencies. In return for receiving their training and Respondent's manuals and other literature, Appellants solemnly promised not to compete with Respondent within thirty-five miles of Riverside for a period of three years or within thirty-five miles of any other Snelling franchise for a period of eighteen months. Here, Respondent has asked for and received relief which places a far lighter burden upon Appellant than the restriction approved in *Pennsylvania Funds* placed upon the former employee.

Pennsylvania's policy in favor of such restrictive agreements is sufficiently strong that its courts will "blue pencil" overly broad covenants, modifying them so that they can be enforced for a reasonable time within a suitable area. *Albee Homes, Inc. v. Caddie Homes, Inc.,* 417 Pa. 177 (1956); *Seligman and Latz of Pittsburgh, Inc. v. Vernillo,* 382 Pa. 161 (1955); *Plunkett Chemical Co. v. Reeve,* 373 Pa. 513 (1953). In the present case, however, they would have no need to "blue pencil" the restrictive covenant

because neither its time nor duration exceeds permissible limits. *Hayes v. Altman,* 424 Pa. 23 (1967) (three years, borough wide); *Beneficial Finance Co. v. Becker,* 422 Pa. 531 (1966) (three years, no geographical restriction); *Barb-Lee Mobile Frame Co. v. Hoot,* 416 Pa. 222 (1965) (five years, state wide); *Pennsylvania Funds Corp. v. Vogel supra* (two years, state wide).

Faced with a covenant which was entirely proper under law which the parties themselves had chosen, the District Court acted properly in enforcing that covenant unless it was certain that a California court would do otherwise. As we shall see, a California state court would have honored Pennsylvania law and taken precisely the same action as the District Court.

B. The District Court Correctly Applied Principles Laid Down by California's District Court of Appeals in Ury v. Jewelers Acceptance Corp. When It Applied Pennsylvania Law and Enforced Respondent's Restrictive Covenant.

The parties to this appeal share some fundamental areas of agreement in approaching questions posed by the restrictive covenant contained in Paragraph 8(b) of the license agreement. Appellants have never questioned the covenant's validity under Pennsylvania law and concede that it is binding if the District Court correctly applied Paragraph 17. We also agree that Federal courts cannot modify state law at will in diversity cases, but must "apply it as they find it." (App. Br. at 15). Judge Duniway, speaking for this Court in *Curry* v. *Fred Olsen Line,* 367 F.2d 921, 924 (9th Cir. 1966), aptly stated the rules which must be followed in evaluating the District Court's decision to apply Pennsylvania law and enforce Paragraph 8(b).

We part company with Appellants, however, when we turn to the question of how California conflict of laws rules governing enforcement of provisions such as Paragraph 17 and 8(b) are to be "found" and applied. Instead of

beginning with the most recent and detailed discussion of the applicable rules in *Ury* v. *Jewelers Acceptance Corp.*, 227 Cal. App. 2d 11 (1964), and then considering the present action in light of those rules, Appellants have attempted to brush *Ury* aside because it did not involve a restrictive covenant. Respondent, on the other hand, believes that *Ury* states fundamental principles which must be considered and applied in all relevant cases.

A careful analysis of the *Ury* case is important precisely because, by their own admission, "Appellants find no California state court appellate decision squarely on the point of whether its public policy against covenants in restraint of competition is sufficiently strong to justify it in ignoring a contract proviso that the law of another jurisdiction apply" (App. Br. at 22). The principles announced in *Ury* provide definite answers to the questions posed by Paragraphs 8(b) and 17, although they are not the answers that Appellants want to hear.

Walter Ury, who owned a retail jewelry and appliance business, in Pittsburg, California, entered into an agreement with Jewelers Acceptance Corporation whereby the Corporation would factor his accounts receivable for an interest charge of 20.3 percent per year. Jewelers Acceptance was based in New York and had adopted a standard form contract which provided that it would be "construed pursuant to the Laws of the State of New York." After the parties had abided by the agreement for four years, Ury withheld payments on the ground that the interest rate amounted to usury. 227 Cal. App. 2d at 13-15.

The interest rate was clearly in violation of Article XX, Section 22, of the California Constitution, which forbids interest in excess of ten percent per annum, except for certain exempt lenders. It would have been usurious in New York, too, but for the fact that the defense of usury is not available to corporate borrowers under its law. To his subsequent regret, Ury had incorporated when Jewelers Acceptance stated that it required customers to incorporate

"in order to assure continuity of the business and of the loan in case of death or divorce," saying nothing about the fact that incorporation would also validate usurious interest rates. 227 Cal. App. 2d at 14.

In upholding the decision below, which had awarded Jewelers Acceptance principal, interest and attorneys' fees of $40,807.68, the District Court of Appeals first noted that the contract was made in New York and required the lender to perform significant acts in that state. It then turned to the parties' stipulation that New York law should govern, holding that the clause resolved any remaining doubts regarding applicable law. 227 Cal. App. 2d at 16-17. Reviewing the choice of law clause, the Court said:

> "It is stated that the contract is to be construed pursuant to the laws of New York, and respondent need not rely on the presumption that Ury read this, because Ury admits that he did. Appellant argues that this provision means only that in case of ambiguity, the contract would be interpreted according to New York law, and that it does not refer to the governing or enforcing of the contract.
>
> "The quoted portion is not nearly so broad as those in other cases which have made it plain that the parties have chosen that the law of a certain state shall prevail in all matters concerning the contract, such as: 'all transactions hereunder shall be governed and construed by the laws of the State of New York' (*Consolidated Jewelers, Inc. v. Standard Financial Corp.* (6th Cir.) 325 F. 2d 31, 33), or 'All questions arising on this contract ticket shall be decided according to English law with reference to which this contract is made' (*Siegelman v. Cunard White Star, Ltd.* (2d Cir.) 221 F. 2d 189, 192)." 227 Cal. App. 2d at 17.

Its remarks clearly indicate that a broad choice of law clause, such as the one found in the Snelling agreement, will be given even greater weight by California courts.

It also relied upon our courts' marked preference for a choice of law which will render a contract enforceable:

> "[A] contract is to be construed so as to make it valid even though foreign law must be applied in order to reach this result. (*Robbins v. Pacific Eastern Corp.,* 8 Cal. 2d 241 [65 P. 2d 42].) In the *Robbins* case, the court construed an agreement which was ambiguous as to place of delivery of stock as being New York rather than California, because the contract would be valid in New York but invalid if it were to be performed in California (p. 274), and New York had a normal and reasonable connection with the transaction (p. 272). In *Terry Trading Corp. v. Barsky,* 210 Cal. 428, 434 [292 P. 474], the court, in a doubtful case of conflict, chose the California law as less drastic than the New York law which would have made an usurious contract wholly void (the borrower was not a corporation)." 227 Cal. App. 2d at 18.

Predictably, Ury contended that California's "strong public policy" against usury precluded the Court from applying New York law. After weighing this contention carefully, it concluded that the public policy was strong, but not strong enough to override the provisions of the contract:

> "That California does not have *such a strong public policy* against any and all contracts which would be usurious if they were made and to be performed here, appears from the fact that the constitutional prohibition of usury, section 22, article XX, of the California Constitution, enacted by initiative, exempts from its provisions banks, building and loan associations, industrial loan companies, credit unions, licensed pawnbrokers and personal property brokers, and several other kinds of lenders, and gives the Legislature the right to prescribe maximum limits for the exempted lenders. A strong public policy, based on a settled concept of justice or morality would not be meshed

with such alterable rates as the Legislature might choose to impose. In fact, the Legislature has imposed no maximum rates for banks. The loan in this case, if it had been made by a bank in California and was payable here, could be enforced.

"In *Nevcal Enterprises, Inc. v. Cal-Neva Lodge, Inc.,* 194 Cal. App. 2d 177 [14 Cal Rptr. 805], it was held that a contract for sale of a gaming establishment in Nevada is not essentially in conflict with the public policy of California, in view of our legitimized horse racing, and suit for accounting would lie." 227 Cal. App. 2d at 20 (Emphasis supplied).

To paraphrase the Court, a strong public policy — even though embodied in the California Constitution — will not prevent the application of foreign law when that policy is subject to significant exceptions.

We need not belabor the similarities between the factors governing the choice of law in the *Ury* case and those governing the choice of law in this appeal. The McDonough contract was made in Pennsylvania at a time when Appellants were not even residents of California. Thereafter, both parties had to perform many activities in Pennsylvania. Robert McDonough went to Pennsylvania for training and had to make regular reports and payments to Respondent's home office in Radnor, Pennsylvania. Respondent trained its franchisees, reviewed their reports, supervised their operations and conducted its national advertising from Radnor. (I R. 125-126; II R. 8:7-9:8; 22: 4-20; 163:8-168:3; 264:14-266:14; MM 241-250) The *Ury* Court, which applied a somewhat ambiguous choice of law clause when it found a "substantial connection" between the contract and New York, 227 Cal. App. 2d at 18, would have had no reason to reach a different conclusion if faced with Appellant's agreement — a contract which had an equally "substantial connection" with Pennsylvania and contained a far clearer choice of law

provision. See also: *People v. Globe & Rutgers Fire Ins. Co.*, 96 Cal. App. 2d 571 (1950).

The California Legislature endorsed the policy set forth above when it adopted Section 1105 of the Commercial Code, which provides:

> "Except as provided hereafter in this section, when a transaction bears a reasonable relation to this State and also to another state or nation the parties may agree that the law either of this State or of such other state or nation shall govern their rights and duties. Failing such agreement this code applies to transactions bearing an appropriate relation to this State."

Far from being irrelevant, as Appellants contend, Section 1105 is an important expression of legislative policy endorsing the freedom of parties to choose applicable law in business transactions. It parallels the present draft of the *Restatement (Second), Conflict of Laws* §332(a), which has adopted a like rule. See: Braucher, *Impromptu Remarks*, 76 HARV. L. REV. 1718, 1718-1720 (1963). If businessmen can select the law of a state which bears "a reasonable relation" to a multi-million dollar equipment financing or a contract for the sale of a few hundred dollars worth of goods, should they be any less free when the contract involves an employment agency in Riverside?

C. California's Prohibition Against Contracts in Restraint of Trade Is Not So Strong as to Preclude the Application of Pennsylvania Law Governing Restrictive Covenants.

The only consideration which could invalidate the District Court's decision is a public policy *so strong* that it prevents application of Paragraph 17 in a case involving a restrictive covenant. As Appellants freely admit, there is "no California state court appellate decision squarely on the point of whether its public policy against covenants in restraint of trade is sufficiently strong to justify it in ignoring a contract proviso that the law of another jurisdiction apply" (App. Br. at 22).

Appellants seek to remedy this deficiency in decisional law by citing California cases which say that this state has a "strong" policy against contracts in restraint of trade. This approach is good advocacy, but bad analysis, because it begs the most significant question: do the provisions of Sections 16600 et. seq. of California's Business and Professions Code express a policy against contracts in restraint of trade which is *so strong* and *so consistent* that it prevents courts from applying a foreign law approving restrictive covenants when the parties to a contract have freely agreed that it should be applied? References to "strong" policy, made in other contexts, do not answer the question because "strong" is not a self-defining term, which carries the same force and meaning in all circumstances.

In *Ury*, the District Court of Appeals examined California's usury laws and determined that they are subject to significant exceptions. Having found that our usury law is not a solid, impregnable, monolith it recognized and applied foreign law even though it did not fit within one of these statutory exceptions. The same approach was followed by the District Court in the present action and should be followed by this Court if it wishes to apply California law "as it finds it."

Section 16600 of the Business and Professions Code is honeycombed with judicially created exceptions although it purports to invalidate "*every* contract by which *anyone* is restrained from engaging in a lawful profession, trade or business of any kind. . . ." (Emphasis supplied). See: *Gordon v. Landau*, 49 Cal. 2d 690 (1958); *Great Western Distillery Products v. John A. Wathen Distillery Co.*, 10 Cal. 2d 442 (1938); *Blank v. Palo Alto-Stanford Hospital Center*, 234 Cal. App. 2d 377 (1965); *Boughton v. Socony Mobile Oil Co.*, 231 Cal. App. 2d 188 (1965); *King v. Gerold* 109 Cal. App. 2d 316 (1952); *Bay Area Painters & Decorators Joint Committee v. Orak*, 102 Cal. App. 2d 81 (1951). In light of our courts' flexible "rule of reason" approach to Section 16600, Appellants cannot seriously contend that

it articulates a stronger, more rigid public policy than our usury laws do.

Like the usury laws, Section 16600 is subject to other important provisions which blunt its impact. Sections 16601 and 16602 provide:

§16601.

> "Any person who sells the goodwill of a business, or any shareholder of a corporation selling or otherwise disposing of all his shares in said corporation, or any shareholder of a corporation which sells (a) all or substantially all of its operating assets together with the goodwill of the corporation, (b) all or substantially all of the operating assets of a division or a subsidiary of the corporation together with the goodwill of such division or subsidiary, or (c) all of the shares of any subsidiary, may agree with the buyer to refrain from carrying on a similar business within a specified county or counties, city or cities, or a part thereof, in which the business so sold, or that of said corporation, division, or subsidiary has been carried on, so long as the buyer, or any person deriving title to the goodwill or shares from him, carries on a like business therein. For the purposes of this section, " subsidiary" shall mean any corporation, a majority of whose voting shares are owned by the selling corporation."

* * * * *

§16602.

> "Any partner may, upon or in anticipation of a dissolution of the partnership, agree that he will not carry on a similar business within a specified county or counties, city or cities, or a part thereof, where the partnership business has been transacted, so long as any other member of the partnership, or any person deriving title to the business or its goodwill from any

> such other member of the partnership, carries on a like business therein."

Putting aside the question of whether either Section specifically validates Snelling's restrictive covenant, the mere existence of such exceptions to Section 16600 — whether or not applicable to Respondent's covenant — demonstrates that California's prohibition of "every contract" in restraint of trade is no stronger than its prohibition against usurious contracts.

Furthermore, the Legislature has been progressively broadening the exemptions from Section 16600 which are provided by Sections 16601 and 16602. In 1945, Section 16601 was amended to permit imposition of a non-competition covenant upon one who disposes of all of his corporate shares. Stats. 1945, c. 671. Just five years ago, Sub-sections (a) through (c) were added to further widen the range of transactions which can result in valid restrictive covenants. Stats. 1963, c. 597. Section 16602 has had a similar history, having been amended in 1961 to expand the area of a valid covenant from "the same city or town" to "a specified county or counties, city or cities". Stats. 1961, c. 1091. It seems strange that the Legislature would repeatedly increase the number of transactions exempt from Section 16600 if, as Appellants contend, our state has an unchanging, unyielding policy.

Additional evidence that California's policy against restraints of trade is no stronger than the policy against usury can be found by examining cases arising under Section 16601. In numerous instances, our Courts have either: 1) validated restrictive covenants not specifically approved by the Section; or, 2) rewritten covenants to make them conform to the statutory scheme. As this Court has already noted, "the California courts have continually strained to put such a construction on covenants in restraint of trade as to save part of the contract, if possible." *Zajicek v. Koolvent Metal Awning Corp. of America*, 283 F.2d 127, 133 (9th Cir. 1960).

The cases in which California courts have "blue penciled" overly broad restrictive covenants to render them enforceable fully support this Court's generalization in *Zajicek*. *Edwards v. Mullin,* 220 Cal. 379 (1934); *Martinez v. Martinez,* 41 Cal. 2d 704 (1954); *Mahlstedt v. Fugit,* 79 Cal. App. 2d 562 (1947). Our courts' policy of attempting to save restrictive covenants is virtually identical to Pennsylvania's policy, which has already been considered.

In both *Gordon v. Landau,* 49 Cal. 2d 690 (1958), and *King v. Gerold,* 109 Cal. App. 2d 316 (1952), agreements were upheld despite the fact that they restrained trade and did not appear to come within the exceptions ennumerated in Sections 16601 and 16602. Landau, plaintiff's former salesman, was held to be bound by an agreement not to use alleged trade secrets for one year following termination of his employment, despite protests that his contract violated Sections 16600 et. seq. Gerold, who had held a license to manufacture King's unpatented house trailer, the "Sport King", was enjoined from producing similar trailers after the termination of his license agreement. 109 Cal. App. 2d at 318. In neither instance, would our courts support an interpretation of California policy which is so rigid and inflexible as the one advocated by Appellant.

California law admittedly invalidates some, but not all, contracts in restraint of trade, just as it invalidates some, but not all, usurious contracts. Our review of the legislative and judicially created exceptions to Sections 16600 et. seq. demonstrates that California's policy against restraints of trade is no stronger than its policy against usury. If there is any meaningful difference between the relative strengths of these policies, the prohibition against usury appears to be the stronger.

In order to sustain the District Court's decision enforcing Respondent's restrictive covenant, this Court must reconsider a decision which it made some forty-four years ago in *Davis v. Jointless Fire Brick Co.,* 300 F. 1 (1924). Despite what Appellants refer to as an "unbroken line of author-

ity" (App. Br. 25), this Court has rarely alluded to *Davis* and the California courts have never cited it for the proposition that a choice of law clause in a contract may be disregarded on some public policy grounds. However, there are more important reasons for reconsidering *Davis* than the fact that it has gathered dust for four decades.

Few bodies of law have changed more rapidly than "conflicts" during the years since 1924. Professor Beale's *Restatement* is retreating into memory. The old, rigid rules are gone forever to be replaced by principles with a new flexibility. With these revolutionary changes has come a new willingness to let businessmen choose the law which will govern their contracts and to enforce the choices — good or bad — which they make. We see this willingness expressed in *Globe & Rutgers, Ury,* the Commercial Code and the new *Restatement.*

While applicable conflict of laws rules have been changing, our courts' and our legislature's views regarding Sections 16600 *et seq.* of the Business and Professions Code have also become less rigid. The development of judicially created exceptions to Section 16600 and the repeated amendments to Section 16601 and 16602 have demonstrated that California has no unyielding policy against contracts which restrain trade. Since 1924, dogmatism has been replaced by a flexibility which yields to economic realities.

These two trends, viewed together, undermine the principal assumptions supporting the *Davis* decision. Before *Ury,* there was room for doubt that *Davis* reflected the probable conclusion which a California court would reach. *Ury* has now resolved the question and commanded the adoption of a more flexible rule if California law is to be followed.

D. The Restrictive Covenant Is Valid and Enforceable Because It Is Incident to a Contract for the Sale or Transfer of Goodwill.

Appellants concede that covenants not to compete are valid if they are incident to agreements for the sale or transfer of goodwill (App. Br. 17-18) and later note that para-

graph 11 of the franchise agreement requires the licensee "to turn over every asset, record and even the telephone in its office, to Snelling" in the event of termination (App. Br. 56-57). "Every asset" clearly includes the goodwill and going concern value of the business, which Respondent is free to resell to a new franchisee.

Assuming the correctness of these propositions, we have some difficulty understanding how enforcement of the restrictive covenant would violate Sections 16600-16602 of the Business and Professions Code if California law governed. Paragraph 11 provides for a transfer of goodwill, and the Code specifically approves restrictive covenants incident to such transfers. Although that Paragraph does not use the magic word "goodwill", its purpose and effect are perfectly clear. Any draftsman could recast the language to recite the admitted fact that a transfer of goodwill occurs on termination without making any change in the substance of the transaction.

Although Appellants may contend that a Snelling franchise is analogous to a license to manufacture a product, *Cf. Zajicek v. Koolvent Metal Awning Corp. of America*, 283 Fd 2d 127 (9th Cir. 1960), there are important distinctions between a manufacturing license and a business franchise. Here, the entire business has been created by the franchisor and is operated by the franchisee in partnership with the national organization. Upon termination, that business reverts entirely to the franchisor. Furthermore, the franchisor does not have patent protection or the common law right to enjoin design copying which the licensor of a manufactured product enjoyed in most jurisdictions prior to the United States Supreme Court's decision, in *Compco Corp. v. Day-Brite Lighting, Inc.*, 376 U. S. 234 (1964).

Given the rapid growth of franchising, it is inevitable that the California courts will be called upon to determine whether a provision like Paragraph 11 constitutes a transfer of goodwill within the meaning of Sections

16601 and 16602. Appellants have pointed the way by giving Paragraph 11 the only logical construction. A transfer of every meaningful asset is a transfer of goodwill. A non-competition covenant incident to such a transfer is as valid as it would be if the magic word "goodwill" had been used.

II. THE DISTRICT COURT CORRECTLY DETERMINED THAT APPELLANTS SHOULD BE ENJOINED FROM EXPLOITING RESPONDENT'S TRADE SECRETS BY OPENING A SAN BERNARDINO OFFICE.

A. The District Court Correctly Determined That Trade Secrets Exist When a Businessman Has Compiled Any Valuable Information Which Gives Him an Advantage Over Competitors Who Do Not Know or Use It.

After hearing evidence on five separate occasions, the District Court found that:

> "Plaintiff's training manuals, and the training and instruction therein given by plaintiff to each of its licensed franchisees and to the employment counselors hired by its licensed franchisees, constitute a compilation of information not available to other persons engaging in the employment agency business, which gives each of plaintiff's licensees a substantial competitive advantage over others engaged in the employment agency business. Defendants McDonough, in receiving plaintiff's manuals and training, derived such competitive advantage from plaintiff. . . ." (I R. 130).

From this Finding, it concluded "that the manuals and the systemized training given in connection therewith constitute trade secrets, the use of which plaintiff is entitled to enjoin and restrain" (I R. 133).

In attacking the findings below, Appellants have constructed and demolished straw men (App. Br. 29-31), weighed equities using the wrong set of scales (App. Br. 32-42), and belatedly turned to the question of whether a compilation of information which gives a businessman a distinct competitive advantage is a "trade secret" entitled

to judicial protection in California (App. Br. 42-51).* The discomforting fact that such information will, indeed, constitute a trade secret when it supplies the possessor with a meaningful competitive advantage almost gets lost in the shuffle.

To determine the correctness of the District Court's decision below, we must reverse the course which Appellants have taken and understand the nature of "trade secrets" before moving on to subsidiary questions. Once we know what "trade secrets" are, we can consider: 1) the effect of a contract provision denominating information as "trade secrets"; and, 2) "policy considerations."

As this Court noted in *Winston Research Corp. v. Minnesota Min. & Mfg. Co.,* 350 F. 2d 134 (9th Cir. 1965) California law is in harmony with Section 757, comment b, of the *Restatement of Torts:*

> "A trade secret may consist of any formula, pattern, device or *compilation of information which is used in one's business, and which gives him an opportunity to obtain an advantage over competitors who do not know or use it.* . . . It may be a device or process which is clearly anticipated in the prior act as one which is merely a mechanical improvement that a good mechanic can make." 350 F. 2d at 139-140, Note 1 (emphasis supplied).

Winston held that a former employee's appropriation of a mechanical improvement in a tape recorder, although based upon well known principles, could constitute unfair competition. 350 F. 2d at 139; see also: *Ojala v. Bohlin,* 178 Cal. App. 2d 292 (1960). As one commentator recently observed:

> "The important fact in a trade secret case is not whether the information is new, or could have been discovered by other means, but whether the employee gained it from his employer via a confidential relationship. If so, he incurred a duty not to use it to the em-

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*We use California law as our reference point because, as Appellants have correctly observed, the trade secret question is moot if Pennsylvania law is applied and the restrictive covenant is enforced (App. Br. 28).

ployer's detriment.'' Von Kalinowski, *Key Employees and Trade Secrets*, 47 VA.L.REV. 583, 592 (1961).

A trade secret is no less valuable and its owner is no less entitled to protection because it may be duplicated by someone else using his own talent and initiative. The owner has produced something of value and should be fully protected against misappropriation. *By-Buk Co. v. Printed Cellophane Tape Co.*, 163 Cal. App. 2d 157, 167 (1958).

Although this principle has most frequently been applied by our courts in ''trade route'' and ''customer list'' cases, liability does not, as Appellants contend (App. Br. 37), turn on the existence of a list or a route. Lists and routes are protected solely because they have taken ''a substantial amount of time, effort and expense to obtain'' and give someone who misappropriates them a competitive advantage which he did not create. Hays, *Unfair Competition — Another Decade*, 51 CAL.L.REV. 51, 52 (1963); see also: *Southern Cal. Disinfecting Co. v. Lomkin*, 183 Cal. App. 2d 431, 444-447 (1960); *Alex Foods, Inc. v. Metcalfe*, 137 Cal. App. 2d 415, 426-427 (1955). Any other compilation of valuable information should be given like protection.

Very little was said below about customer lists and contacts. However, Appellants unquestionably have both. They advertised regularly in San Bernardino and received San Bernardino business for two years prior to the letter of ''recission'' (II R. 27:9-30:17). During that two-year period, while Robert E. McDonough was still a Snelling franchisee, he inevitably built up contacts with potential employers in San Bernardino — contacts that he could exploit to Respondent's detriment if he were allowed to open a San Bernardino office:

> ''Q In your business do your employment counselors attempt to establish contacts with the prospective employers for people you are trying to get jobs for?
>
> A In San Bernardino?

Q Yes.

A Oh yes.

Q And have you contacted employers in the San Bernardino area?

A Oh yes, absolutely, daily" (II R. 29:3-11).

Although McDonough's records enhance his ability to destroy Snelling's franchisee in San Bernardino, they are not the essence of Respondent's cause of action. Respondent's right to injunctive relief would exist if he had no records at all, since Snelling has given him other valuable, protectable information.

The notion that Respondent's training, its manuals and the information imparted to managers at periodic seminars are less valuable and entitled to less protection than routes or lists is dispelled by *American Loan Corp. v. California Commercial Corp.*, 211 Cal. App. 2d 515 (1963), which involved similar trade secrets. In *American Loan,* defendant Rooney had appropriated both the customer list and the training manual employed in an investment business and proceeded to set up a rival firm in Riverside County. When it affirmed the trial court's decision enjoining such unfair competition, the District Court of Appeals recognized that both the lists and the manuals contained valuable trade secrets:

> "[I]n order that it [Plaintiff's business] be understood by employees, he developed, over a period of months, for the confidential use of employees, a training manual covering all phases of the business. Rooney had a copy of this manual. . . . [T]he evidence shows that the information relative to the conduct of the business was of a type not readily obtainable in general business circles in the Riverside-San Bernardino area; that plaintiffs spent several months of study, many hundreds of dollars in tutelage, and experience in developing a particularly complicated type of ap-

> proach to sale of real estate secured credits on a piece-meal basis; *that the only other available source of such information known to any witness was by obtaining membership in a national organization at a cost of $3,500;* that the list of customers, contrary to defendants' contention, was *not* easily obtainable from recorded instrument lists nor was the information as to the purchasing habits of these customers obtainable in any other way than by reference to the index cards and Rooney's personal memory." 211 Cal. App. 2d at 518, 523 (emphasis supplied).

If information which can also be obtained by purchasing "membership in a national organization at a cost of $3,500," is protectable when developed by an individual entrepreneur, it follows that the "national organization" is entitled to protection. Another businessman in Riverside would have done well to profit by Mr. Rooney's example.

B. The District Court's Determination That Respondent's Training Course, Manuals and Management Seminars Contain Valuable Trade Secrets Is Supported by Substantial Evidence.

Appellants have captured the essence of California trade secret cases by observing that each decision turns upon a careful examination of facts and circumstances (App. Br. 32-33). Hays has also observed that the existence or non-existence of protectable trade secrets will depend upon factual considerations. Hays, *op. cit. supra* at 51.

Having grasped the importance of factual issues, Appellants proceed to disregard accepted principles governing appellate review of findings of fact (App. Br. 44-51). In order to support their interpretation of relevant evidence and contend that it "is all one way" (App. Br. 49), Appellants must stand the accepted rule on its head and construe all evidence in the manner most favorable to overturning the decision below.

Among the District Court's detailed findings was its determination that Snelling's initial training, manuals and

management seminars contain information, not readily available to other persons engaging in the employment agency business, which Appellants could use to obtain an advantage over competitors who do not know or use it (I R. 130; Finding of Fact 27). Appellants' cavalier treatment of established rules begins with their disregard of this Court's Rule 18(2)(d) which required them to specify "as particularly as may be" wherein that finding was wrong, *Commissioner of Internal Revenue v. Seaboard Finance Company,* 367 F. 2d 646, 650-652 (9th Cir., 1966); but, it does not end there.

This Court does not "sit to second guess the trial court, nor have . . . the power to do so under Rule 52(a) of the Federal Rules of Civil Procedure, 28 U.S.C.A., unless the findings are 'clearly erroneous.' " *Bloom v. United States,* 272 F. 2d 215, 223 (9th Cir., 1959). Appellants are charged with the burden of showing that the District Court's findings are "clearly erroneous." *Stephens v. Arrow Lumber Co.,* 354 F. 2d 732, 734 (9th Cir., 1966).

The finding that Snelling's manuals, initial training and management seminars contain a unique compilation of business information and techniques which give Appellants distinct competitive advantages is supported by substantial evidence which is reviewed in some detail in Respondent's Statement (pp. 11-14, *supra*). For example, Damon Wheeler explained the significant competitive advantage which he had received from the Snelling system and his resulting success as Respondent's Sacramento franchisee (II R. 84:21-85; 21; 95:10-96:15; 101:3-10). Respondent's Vice President, John McBrearty, detailed the planning and preparation of management seminars which are preceded by research into problems revealed by franchisee's periodic reports (II R. 163:8-169:7). Finally, the court had before it all of the Snelling manuals, including the important Manager's Manual which explains the detailed record keeping and reporting procedures that enable a franchisee to maintain internal controls and permit Respondent's head

office to detect weaknesses in the system (II R. 11; Pl. Ex. 1).

Counterbalancing this evidence was: 1) Robert E. McDonough's self-serving testimony that he had received no unique training or information from Snelling (II R. 32:21-33:3; 53:2-55:9); 2) Elinor Still's testimony that Snelling offers nothing unique *except* its record keeping, reporting system and some suggested practices which she dislikes (II R. 74:20-76:21); and, 3) a mixed bag of manuals which McDonough had gathered together (II R. 147:9-153:19; D. Ex. B). James Chadwick's testimony that he paid substantial consideration for training which he hoped would be similar to the Snelling system, though offered on behalf of Appellants, establishes that Respondents have something of value (II R. 156:19-157:4).

The District Court's finding is adequately justified by the evidence if no allowances are made for the biases of Robert E. McDonough and Elinor Still. However, it is reenforced when consideration is given to their hostility toward Respondent — a practice specifically approved by this Court in *Pursche v. Atlas Scraper and Engineering Co.*, 300 F. 2d 467, 485 (9th Cir., 1962):

> "The Court's findings were contrary to the direct testimony on the subject, but this evidence was all adduced from interested witnesses and was countered by substantial mute evidence from which the facts found by the trial court can be inferred. We are not convinced that the several findings of the district court are 'clearly erroneous'. . . ."

Here, as in *Pursche*, the Court had a substantial amount of "mute evidence" before it in the form of Snelling's manuals.

Faced with a reasonable finding that Snelling's techniques embody valuable information which gives a substantial advantage over competitors who neither know nor use the system, Appellants attempt to undercut it by recon-

sidering the evidence in the light of six factors which, according to Section 757, comment (b) of the *Restatement of Torts,* are "to be considered in determining whether given information is one's trade secret" (App. Br. 43-49):

> "(1) the extent to which the information is known outside of his business; (2) the extent to which it is known by employees and others involved in his business; (3) the extent of measures taken by him to guard the secrecy of the information; (4) the value of the information to him and to his competitors; (5) the amount of effort or money expended by him in developing the information; (6) the ease or difficulty with which the information could be properly acquired or duplicated by others."

If anything, "consideration" of these six factors strengthens Respondent's claim to trade secret protection when the evidence presented below is viewed objectively and not painted in vivid colors with a broad brush.

At the outset, we should note that three different classes of information are involved in Respondent's trade secrets: (1) information given to the franchisee-manager when he is trained in Pennsylvania; (2) procedures and techniques outlined in the various manuals; and, (3) management studies and techniques presented at Snelling's management seminars. The nature and significance of the manuals varies, with the Manager's Manual containing more vital and detailed information than either the Receptionist's Manual or the Counselors' Manuals. While both John McBrearty and Damon Wheeler were familiar with all three classes of information (II R. 88:3-94:21; 161:9-169:17), there is nothing in the record to indicate that any one of Appellants' witnesses, other than Robert E. McDonough, was familiar with all three types — Pennsylvania training, manuals and management seminars.

Difficulty of Duplication

There is no evidence at all that a person outside the Snelling system can obtain training comparable to that which Respondent gives in Pennsylvania (II R. 88:16-21) and at its management seminars (II R. 163:8-168:3). By their very nature, the Pennsylvania training and the seminars are unique to the Snelling system.

While other handbooks may be available (II R. 147:9-153:19; D. Ex. B), they do not match Respondent's set of manuals in their overall detail and in the thoroughness of Snelling's record keeping and reporting procedures, which are essential to efficient operation. Damon Wheeler, who was familiar with personnel agencies from years of experience as a management consultant, was convinced that costly trial and error would be the only alternative to obtaining Snelling manuals and training (II R. 101:3-10).

Effort or Money Expended

In an unbending, uncompromising mood, Appellants refuse to concede that National Supervisors who are available on call (II R. 105:25-107:9), the managerial manuals which Robert O. Snelling, Sr., devised (II R. 11; Pl. Ex. 1), the Snelling training course (II R. 88:16-21), *or* the management seminars and underlying research (II R. 163:8-168:3) cost money (App. Br. 47). The expenses entailed in developing such programs and materials are apparent on their face. Appellants cannot seriously contend that they are less than the costs of opening a loan company in Riverside, *American Loan Corp. v. California Commercial Corp., supra,* or a business selling restroom disinfectants in Los Angeles, *Southern Cal. Disinfecting Co. v. Lomkin, supra.*

Value of the Information to Snelling and its Franchisees

Unwilling to concede anything, Appellants suggest that information and business techniques which form the foundation of a nationwide system yielding an annual gross income

of $1,512,867 (II R. 178:6-8)— or 7% of franchisees' gross income of roughly $21,500,000 — have no value (App. Br. 46). Damon Wheeler was sufficiently convinced of their value that he purchased a Sacramento franchise after years of working with Snelling and other personnel agencies (II R. 86:8-93:10; 101:3-10). Little more than a year ago, Robert E. McDonough conceded their value when he expressed an interest in remaining a franchisee, provided that his override could be reduced (I R. 56-58; see particularly: I R. 57).

Protecting Trade Secrets

When we consider Respondent's diligence in guarding trade secrets, we must distinguish between actions which it could have brought against former counselors, who merely have access to the Counselor's Manual, and actions against franchisee-managers, who have had access to the initial training, the Managers' Manual, and management seminars (II R. 254:19-255:2). Once that distinction has been made, other classes within the managerial subgroup assume importance: 1) the former franchisee who had access to trade secrets, but never really learned the system or is so hopelessly incompetent as to be no threat (II R. 188:8-190:2); 2) former franchisee who operates in an area where Snelling has no offices (II R. 191:7-192:6); and, 3) the capable franchisee, like Robert E. McDonough, who would compete directly with Respondent's other franchisees by opening a new office. (II R. 134:22-135:7). Only the last of these really endangers the Snelling system (II R. 134:22-135:7; 188:8-190:2).

Since a relatively limited group can harm Respondent substantially, the fact that Snelling "has sought to prevent but six former employees or franchisees from utilizing their trade secrets until the present suit" (App. Br. 46) would indicate reasonable diligence in policing a franchise system when very few former franchisees have attempted to compete — if it told the whole story. However, the only wit-

ness to be examined at length regarding litigation had become Respondent's Vice President just a year and a half before the hearing below and could not detail all legal actions taken prior to that time (II R. 212:2-213:21).

Furthermore, Appellants assume that trade secrets have been permanently lost and that Respondent is without recourse where it has failed to seek injunctive relief *pendente lite* to close down an existing office (II R. 134:22-135:7). The fallacy of this proposition is demonstrated by the *LaPerch & Mills* case, where Snelling did not seek preliminary relief, but has had an injunction enforcing the restrictive covenant approved and entered since the District Court completed the proceedings below. See: *William LaPerch and W. J. Mills, Partners dba Snelling & Snelling v. Snelling & Snelling, Inc.*, L.A. Superior Ct. No. 863092.

Respondent has not been so litigious as to sue every former franchisee or corporate employee who came near another employment agency. If a former franchise salesman did not know the system, a former supervisor did not use it, or a former franchisee was incapable of exploiting it, Snelling stayed its hand and saved its treasury (II R. 188:8-190:2; 208:19-209:23; 227:19-228:22). This seems like an eminently reasonable course since the law does not — as Appellants suggest — require litigation with all real or imagined malefactors in order to preserve trade secrets.

Limitation of Access

Appellants' assertion that Respondent's trade secrets are "widely known by all employees of appellee, by the franchisees and the employees of the franchisees" (App. Br. 46) will not withstand examination. As we have repeatedly pointed out, only the franchisee-managers receive training in Pennsylvania, attend periodic management seminars and have continuing access to the Manager's Manual (II R. 105:12-24; 163:8-169:17; 254;19-255:4). Some counselors may receive some training in Pennsylvania (254:

25-255:2), but there is no evidence in the record that a significant number do. Furthermore, there is no evidence that anyone other than Robert E. McDonough has the contacts with employers in San Bernardino that he built up while a Snelling franchisee (II R. 27:9-30:17).

Even if we assume there is some leakage of information from the Snelling system, that fact does not permit Appellants to misappropriate Respondent's trade secrets. Although Appellants have cited no California decisions dealing with the effect of casual leakage of information upon the availability of trade secret protection, such authority as does exist indicates that it will not prevent injunctive relief. For example, in *Ungar Electric Tools, Inc. v. Sid Ungar Co., Inc.,* 192 Cal. App. 2d 398, 404 (1961) the District Court of Appeals upheld an injunction despite the fact that important aspects of plaintiff's trade secrets may have been disclosed by patents. Such a decision is eminently reasonable since no business can conform to the information control standards of the Central Intelligence Agency and still function efficiently.

Knowledge of Secrets Outside of the System

The question of whether, as Appellants claim, "all employment agencies in California use substantially the same methods, procedure and policies" (App. Br. 44) has already been dealt with (pp. 11-14 *supra*). All we need in conclusion is that trade secret protection as we have known it in California is dead if denial of injunctive relief can rest on testimony that no secret exists which is given by someone who: 1) accepted information in confidence over a substantial period of time; and, 2) would have maintained his confidential relationship if he could have negotiated a better business arrangement (II R. 56). If trade secret protection is to die, it should be sacrificed to a better cause than expansion of Appellants' business.

C. The District Court's Decision That Respondent Has Protectable Trade Secrets Is Supported by the Express Understanding of the Parties.

Appellants have signed an agreement acknowledging the receipt of confidential information and pledging to respect its confidentiality. (I R. 89-92; see particularly: Paragraphs 8 and 11(g)). When they observe that such a contract cannot transmute common knowledge into "trade secrets" if no valuable collection of information exists (App. Br. 29-30), they state the traditional California rule, but beg the really interesting question: Should such understandings be given weight where a dispute exists regarding the existence of trade secrets?

In *State Farm Mutual Ins. Co. v. Dempster,* 174 Cal. App. 2d 418, 426 (1959), the District Court of Appeals held that a contractual provision was "not decisive" in determining the existence of trade secrets, but would be given some weight. To some extent, the "protected interest" is regarded as a product of the "accepted relationship of the parties." 174 Cal. App. 2d at 426.

As Hays noted, our courts traditionally have accorded some deference to the parties' expressed views and intentions where there is doubt regarding the existence of confidential information. Hays, *op.cit. supra* at 61, 69-70; see also: *By-Buk Co. v. Printed Cellophane Tape Co., supra* at 164 (1958). If this were a close case, a California court would undoubtedly consider Appellants' pledge to respect the confidentiality of Snelling's techniques in deciding that Respondent has protectable trade secrets.

The traditional rule, which was followed in *State Farm* and restated by Hays, was seriously undermined in December of 1966. In deciding *Ernst & Ernst v. Carlson,* 247 Cal. App. 2d 125 (1966), the District Court of Appeals held that one who receives information in confidence can be enjoined from using it to interfere with another's business *even though he has not been entrusted with a true trade secret:*

> "Any unwarranted disclosure of confidential information constitutes a breach of trust and equity will restrain any threatened disclosure or use thereof by an employee or former employee to the detriment of the employer. The character of the information, if peculiar and important to the business, is not material. (*Riess v. Sanford,* 47 Cal. App. 2d 244 [117 P. 2d 694].)
>
> Most of the cases discussed by the parties relate to trade secrets and the like, but the jurisdiction of equity is not so confined. In *Riess v. Sanford, supra,* 47 Cal. App. 2d 244, 247, the following quotation appears, in approval of a similar statement from the opinion of Mr. Justice Holmes in *E. I. DuPont de Nemours Powder Co. v. Masland,* 244 U.S. 100, 102 [61 L.Ed. 1016, 37 S.Ct. 575]: '. . . that the "starting point" is not property or due process of law but the confidential relation between the parties and that "Whether the plaintiffs have any valuable secret or not, the defendant knows the facts, whatever they are, through a special confidence that he accepted. The property may be denied but the confidence cannot be. . . . The first thing to be made sure of is that the defendant shall not fraudulently abuse the trust reposed in him. It is the usual incident of confidential relations. If there is any disadvantage in the fact that he knew the plaintiffs' secrets, he must take the burden with the good.' " 247 Cal. App. 2d at 128-129.

While the *Ernst & Ernst* case goes further than earlier California decisions, it is in accord with the view that misappropriation of "commercial intangibles"—i.e., ideas, information or goodwill—is actionable even though true trade secrets are not involved. Comment, *Competitive Torts,* 77 HARV. L. REV. 888 (1964). As the latest pronouncement of a California appellate court, it lends further support to the relief granted by the District Court. Having accepted Respondent's training and manuals in confi-

dence, Appellants cannot now claim that they contain no trade secrets.

D. The District Court's Decision That Respondent Has Protectable Trade Secrets Accurately Reflects Policy Considerations Which Prompt California Courts to Grant Injunctive Relief.

Before we leave the question of Respondent's trade secrets, something must be said regarding the discussion of "competing policy considerations" which forms a substantial portion of Appellants' argument (App. Br. 32-42). As we have already suggested, Appellants employ the wrong set of scales in "weighing the equities" because this is not a conventional employer-employee case. Robert E. McDonough was not a job applicant who had little bargaining power when he approached a potential employer, but a knowledgeable businessman with capital to invest, who negotiated an arms length transaction with the advice of counsel (II R. 7:18-8:1; 8:11-20; 50:7-51:4). When he attempted to renegotiate his contract, McDonough could and did demand that he be given a better deal as the price for continuing to respect Snelling's trade secrets (I R. 57).

Assuming for the sake of argument that the employer-employee cases are relevant, the equities weigh heavily in favor of Respondent because it is merely attempting to maintain the status quo, not to prevent Appellants from continuing to operate the business which they established through a Snelling franchise. Accepting the test which this Court announced in *Winston,* Respondent seeks minimal protection for the interests which it represents at minimal cost to the interests represented by Appellants:

> "On the one hand, restrictions upon the use and disclosure of such information limit the employee's employment opportunities, tie him to a particular employer, and weaken his bargaining power with that employer. Such restrictions interfere with the movement to the job in which he may most effectively use

his skills. They inhibit an employee from either setting up his own business or from adding his strength to a competitor of his employer, and thus they diminish potential competition. Such restrictions impede the dissemination of ideas and skills throughout industry. The burdens which they impose upon the employee and society increase in proportion to the significance of the employee's accomplishments, and the degree of his specialization.

"On the other hand, restrictions upon an employee's disclosure of information which was developed as a result of the employer's initiative and investment, and which was entrusted to the employee in confidence, are necessary to maintenance of decent standards of morality in the business community. Unless protection is given against unauthorized disclosure of confidential business information by employees, employee-employer relationships will be demoralized; employers will be compelled to limit communication among employees with a consequent loss in efficiency; and business espionage, deceit, and fraud among employers will be encouraged." *Winston Research Corp. v. Minnesota Min. & Mfg. Co., supra* at 137-138.

This Court's reference to the high cost of encouraging piracy of business and trade secrets is particularly appropriate in light of Appellants' conduct and relevant California law. Former business associates "dilute the value" of precedents in their favor "by engaging in tactics repugnant to common ethics." Hays, *op. cit. supra* at 51. Thus, a former employee who felt that his conduct was protected by the California Supreme Court's decision in *Aetna Bldg. Maintenance Co. v. West,* 39 Cal. 2d 198 (1952), had a rude awakening when the District Court of Appeals held that the normal rules of the weighing game do not apply when equity has been diluted by sharp practice and affirmed an order granting injunctive relief:

> "There is no statement in the *Aetna* case to the effect that where fraud, deceit, breach of contract and deception are present, as they are so present in the case at hand, the business of plaintiff is open to invasion on the part of a former employee and a scheming entrepreneur." *Southern Cal. Disinfecting Co. v. Lomkin, supra* at 53.

Consider for a moment the conduct of the scheming entrepreneur who has brought this appeal. Robert E. McDonough breached his contract with Respondent after nine months of successful operations by refusing to pay his seven percent override, but waited more than a year before attempting to "rescind" that contract (I R. 26-29; 56-57). After his breach, but before "rescission", he continued to advertise his membership in the Snelling system (II R. 37:9-38:7) and attend Respondent's management seminars (II R. 168:4-169:7). While he was actively negotiating to obtain a more favorable contract, McDonough was training counselors so that he could open a San Bernardino office in competition with Snelling's existing licensee (II R. 41:15-25; 282:15-285:1). Franchisees can be protected and competition encouraged without rewarding his freebooting free enterprise.

III. THE DISTRICT COURT FOLLOWED ACCEPTED EQUITABLE PRINCIPLES AND ACTED WITHIN THE LIMITS OF ITS DISCRETION IN GRANTING INJUNCTIVE RELIEF.

A. A District Court Has Discretion to Grant Injunctive Relief When a Controversy Presents Grave and Difficult Questions of Law and Fact and Preservation of the Status Quo Will Minimize Possible Injury.

If we have discussed the legal and factual issues raised by this action in far more detail than seems warranted, in an interlocutory appeal from an order granting a preliminary injunction, it is because Appellants have insisted upon treating the proceedings below as a final adjudication of the merits of Respondent's case. Appellants seem to

forget that this is an interlocutory appeal in which particular standards are to be applied in determining the correctness of a decision below. In fact, their brief says nothing at all about the basic rules governing appeals from orders granting preliminary injunctions.

A plaintiff seeking a preliminary injunction is not required to prove conclusively that the defendant has no defenses and that he will prevail at trial. It is sufficient if a plaintiff, in his application for injunctive relief, raises grave and difficult questions of law and fact. If he has done so, the court's discretion should be exercised in his favor so that the *status quo* will be preserved until the merits of his case, and the merits of any defenses, can be tested at trial. As Judge Stephens observed in *Ross-Whitney Corp. v. Smith, Kline and French Labs.*, 207 F 2d 190, 194 (9th Cir. 1953):

> "[T]he ruling on the motion for a preliminary injunction leaves open the final determination of the merits of the case. However . . . it is the rule in this circuit that the district court has not abused its discretion if 'the possibility that the plaintiff may make out a case upon the merits' has been established. *Northwestern Stevedore Co.* v. *Marshall,* 9 Cir. 1930, 41 F. 2d 28, 29."

Judge Pope expanded on the same theme in *Burton* v. *Matanuska Valley Lines,* 244 F. 2d 647, 650-651 (9th Cir. 1957):

> "[An interlocutory] injunction preserves the *status quo* and protects plaintiff from irreparable injury during the pendency of a suit until such time as the court may adjudge and finally determine the rights of the parties. Necessarily the court may pre-suppose that in the case at bar it *may* turn out that the plaintiff will ultimately lose. Thus the court *may* finally find the facts against the plaintiff who procured the temporary injunction. But this *possibility* does not compel a

denial of a temporary injunction if proper showing be made therefore; otherwise a court, which necessarily requires time to reach a final determination, would have no way to protect a party who may suffer irreparable loss if the *status quo* is not preserved. Without this power to issue interlocutory injunction, courts would be unable to make their final judgments effective, for the very right to be protected, or the subject of the action itself, might be destroyed irreparably during the period required to arrive at an ultimate determination of the action.

"And just as a court must of necessity obtain time in which to determine which party is right upon the facts, so in a substantial number of cases time is necessarily required to resolve grave, difficult and complicated questions of law. If, in such a case, it is ultimately decided that the party who obtained the temporary injunction cannot win, that in itself does not demonstrate that it was wrong to issue the injunction. For a considerable latitude of judicial discretion is allowed the trial court in its determination whether the situation requires a preservation of existing conditions through an injunction *pendente lite*, and [the appellate court's] more deliberate conclusion that the ultimate decision must be against a permanent injunction does not in itself warrant a reversal of the interlocutory order. [Emphasis the court's]

*　*　*

"And in *Ohio Oil Co. v. Conway*, 279 U.S. 813, 815, 49 S.Ct. 256, 73 L.Ed. 972, the Supreme Court . . . said: 'Where the questions presented by an application for an interlocutory injunction are grave, and the injury to the moving party will be certain and irreparable, if the application be denied and the final decree be in his favor, while if the injunction be granted the injury to the opposing party, even if the final decree

> be in his favor, will be inconsiderable, or may be adequately indemnified by a bond, the injunction usually will be granted.' "

It is equally well settled in this Circuit that the granting of a preliminary injunction is largely within the discretion of the District Court. Absent a manifest abuse of discretion, its decision will not be overturned on appeal. *B. W. Photo Utilities v. Republic Molding Corporation*, 280 F. 2d 806, 807 (9th Cir. 1960); *Burton v. Matanuska Valley Lines, supra* at 650-651; *Alfa Distributing Co. v. James Barclay and Co.*, 215 F. 2d 510, 511 (9th Cir. 1954); *Ross-Whitney Corp. v. Smith Kline and French Laboratories, supra* at 194 (9th Cir. 1953).

Appellants have not argued — because they cannot argue — that this case fails to present grave and difficult questions of law and fact. The vigor with which Appellants have argued their case and the skill and energy exercised in briefing this appeal attest to the gravity and difficulty of the issues presented. The time and attention which the District Court devoted to the proceeding below indicates that it gave serious consideration to the legal and factual issues presented and was careful to avoid any abuse of discretion.

B. No Equitable Considerations Exist Which Should Have Precluded the District Court From Granting Injunctive Relief.

Appellants advance three makeweight arguments to support the proposition that equitable principles dictate denial of injunctive relief, contending that the Snelling agreement is: 1) an unenforceable personal service contract; 2) the product of fraud and deceit; and, 3) "unconscionable" (App. Br. 51-58). Two of these can be dealt with summarily. The third requires somewhat more attention because Appellants attack the entire Snelling system and seek to enlist this Court's aid in destroying it.

Assuming for the sake of argument that a California court would find the Snelling franchise to be a "personal

service contract", it would still grant injunctive relief, just as it has in numerous trade secret cases which clearly involved personal service contracts. e.g., *Gordon v. Landau,* 49 Cal. 2d 690 (1958); *State Farm Mutual Ins. Co. v. Dempster,* 174 Cal. App. 2d 418 (1959). Such relief would also be granted under Pennsylvania law, which the parties have chosen to govern their contract. *Pennsylvania Funds Corp. v. Vogel,* 399 Pa. 1 (1960). The proprietary of enforcing an express or implied covenant not to compete when affirmative performance of a personal service contract cannot be compelled has been recognized since the Chancellor silenced Madame Wagner. *Lumley v. Wagner,* 42 Eng. Rep. R. 687 (1852); 4 Witkin, SUMMARY OF CALIFORNIA LAW 2816-2817 (1960).

Respondent's "fraud" consists of its alleged failure to tell Robert E. McDonough that he could not use "Snelling & Snelling" as an integral part of his licensed name in California although he could: 1) identify himself as "a member of Snelling & Snelling" in all of his advertising; 2) use the registered Snelling trademarks; and, 3) obtain a telephone listing and place telephone advertising under the name "Snelling & Snelling". (II R. 37:7-38:6; 260:3-262:25). As we have already noted, burdensome restrictions on use of the Snelling name in telephone advertising occurred well after execution of Appellants' franchise agreement (II R. 31:12-24; 263:16-264:2).

Assuming that Respondent's officers failed to tell McDonough of the California problem, the possibility of incidental limitations on use of the Snelling name is still fully disclosed by Paragraph 1(c) of the license agreement which was reviewed by his counsel (I R. 87; II R. 8:21-9:8). Paragraph 1(c) expressly provides that *"Licensee shall use only the name Snelling and Snelling . . . unless state law requires other or additional identification."* Furthermore, Appellants' first recorded protest against alleged "fraud" occurred more than two years after the opening of their office, when Respondent sought

to terminate their franchise for non-payment of overrides (I R. 26, 57).

When Appellants ask this Court to find that the basic Snelling license agreement is "unconscionable," they seek to destroy Respondent's entire business by invalidating similar contracts with more than two hundred-fifty licensees. Such a decision should not be made lightly when the contention that a contract is unconscionable has been raised and fully litigated below. Here, the question should not be reached at all because it was never presented to the District Court, was not mentioned in Appellants' Statement of Points (I R. 146-147), and is barely suggested in the Specifications of Errors (App. Br. 12-13).

Despite Appellants' failure to raise the "unconscionable contract" argument at an appropriate time, it cannot be passed over without comment. Their scattershot attack contains far too many errors and unfounded assertions to go unchallenged. Some of the sections mentioned in this running attack (App. Br. 51-58) have already been dealt with and need not be reconsidered. Several others are of little importance, but a few require particular attention.

Paragraph 1(d)

While Paragraph 1(d) gives the franchisee a time limit within which to open his office, there is nothing in the record to indicate that: 1) it is unreasonably brief; 2) it has ever posed a problem for *any* franchisee; or, 3) it has ever been enforced. If it had been questioned below, evidence could have been presented to establish that it poses no hardship.

Paragraph 2

While Snelling is given substantial latitude in selecting the time, place and manner of supplemental training, the record amply demonstrates that such training was and is freely given. Respondent's course of dealing with franchisees establishes that Snelling has not sought to avoid

responsibilities to its franchisees, but, instead, has developed comprehensive programs for their benefit (II R. 88:22-89:13; 105:25-107:9; 163:8-171:14).

Paragraph 4

The allegedly burdensome reports do permit Snelling to determine whether franchisees are paying their overrides, but serve an equally important function as well. From them, Respondent's headquarters in Pennsylvania can determine strengths and weaknesses in the system and prepare remedial training programs (MM 241-250; II R. 163: 18-171:14).

Paragraph 5

Although a minimum gross receipts schedule is provided, it is so ridiculously low as to be meaningless. In his first months as a franchisee, Robert E. McDonough's monthly receipts of $5,000.00 were well in excess of the required minimum monthly receipts for his *tenth* year of operations (II R. 22:4-20; Pl. Ex. 2).

Paragraph 11

Respondent's "massive powers" in the event of termination are required to protect its interest in trade lists, contacts and goodwill which the franchisees have developed while operating as Snelling representatives. They are no harsher than similar powers approved in *Gordon v. Landau, supra* and *State Farm Mutual Ins. Co. v. Dempster, supra.*

Paragraph 12

Appellants' criticism of Paragraph 12 results from a failure to read the typewritten addendum to the Mcdonough agreement, which substitutes a less burdensome provision for the terms of the original form (I R. 24). Although the original Paragraph 12 has not been stricken from the printed agreement, there can be no doubt that the typewritten language was substituted for it if the two provisions are placed side by side.

Paragraph 14

Although the provision that a sale of the license must be effected within sixty days of the franchisee's death can probably be avoided if the franchisee incorporates, as he is permitted to do (I R. 25), Paragraph 14 does seem overly restrictive until one remembers that many valid contracts are terminable on the death of a party. The transfer fee is also understandable and reasonable since Snelling must train the new owner and perhaps sustain a loss while he is breaking into the business (II R. 232:1-17).

California's courts have been relatively unreceptive to the notion that parties should be able to escape a contract by arguing that some of its terms are "unconscionable". *Smith v. Mendonsa,* 108 Cal. App. 2d 540, 544 (1952). Similarly, they have consistently favored severing invalid provisions where the contract can be saved by doing so. *Keene v. Hartling,* 61 Cal. 2d 318, 321-324 (1964); *Calvert v. Stoner,* 33 Cal. 2d 97, 104 (1948); *Werner v. Kroll,* 89 Cal. App. 2d 474, 476 (1948); *cf. Zajicek v. Koolvent Metal Awning Corp. of America, supra* at 133.

Appellants have greatly exaggerated the effects of the various paragraphs which they attack and have ignored facts and circumstances which mitigate any burden that some provisions may place upon franchisees. If, however, they are ultimately able to convince the District Court that one or more of these is, in fact, unduly burdensome, Appellants' proper remedy is severance pursuant to Paragraph 16 and not invalidation of the basic Snelling agreement.

C. The District Court's Finding That Denial of Injunctive Relief Would Cause Irreparable Injury Is Supported by Substantial Evidence.

In the typical California trade secret case, such as *State Farm* or any one of the *Gordon* decisions, *e.g., Gordon v. Landau, supra; Gordon v. Wasserman,* 153 Cal. App. 2d

328 (1957)); *Gordon v. Schwartz,* 147 Cal. App. 2d 213 (1956), injunctive relief has been granted against a former employee who has stolen a few customers. The courts have had little difficulty in finding "irreparable injury" where the direct loss to the plaintiff has been small and the total impact upon his business has been minimal.

Here, on the other hand, the substantial direct economic impact upon Respondent and its San Bernardino franchisee has been compounded by the fact that the McDonough rebellion, if allowed to go unchecked, would induce the breach of other franchise agreements. John McBrearty's testimony regarding the substantial loss which Respondent would suffer has already been reviewed in detail (pp. 14-15, *supra*) and need not be reconsidered. In evaluating that testimony, the District Court was impressed by the interest which other franchisees showed in the proceeding below and Elinor Still's use of it as a vehicle to stir revolt within the Snelling system (I R. 130-131; 43:1-46:14; 49:18-25; 72:9-18). Its factual finding of substantial irreparable injury is fully sustained by the record and contains no conclusions which are arguably erroneous.

Little need be said regarding the fact that the District Court placed some reasonable limits on John McBrearty's testimony regarding the nature and source of Respondent's problems with rebellious franchisees and their contribution to probable injury. Appellants have mentioned these limitations in passing (App. Br. 12-13), but have not pressed the contention that they constitute reversible error. Since the question of Respondent's problems with franchisees was explored in some detail, the rejected line of questioning would merely have produced cumulative testimony. A District Court is given wide discretion to exclude cumulative evidence, *Woods v. National Life & Accident Ins. Co.,* 347 F. 2d 760, 766-767 (3rd Cir. 1965); *Gypsum Carriers, Inc. v. Handelsman,* 307 F. 2d 525, 531 (9th Cir. 1962), and did not abuse that discretion here.

CONCLUSION

Unlike Appellants, Respondent does not believe that this Court must prejudge all of the difficult legal and factual questions which will arise at trial. By definition, the decision of the District Court is a preliminary one which was made to preserve the *status quo* pending trial and not a final disposition of this controversy. We have discussed basic legal and factual questions at far greater length than would otherwise have been warranted primarily because Appellants have treated the proceedings below as a final adjudication of those issues.

Unlike Appellants, we urge no departure from established rules governing review of findings of fact and conclusions of law. Factual findings should be upheld unless they are clearly erroneous. *Bloom v. United States, supra.* Similarly, a District Court's interpretation of the law of the state in which it sits is entitled to great weight. *Bellon v. Heinzig,* 347 F. 2d 4, 6, Note 3 (9th Cir. 1965).

With these principles in mind, there can be no real question regarding the propriety of the decision below. When the merits of the controversy are reached and the record is viewed objectively, there is also no room for doubt that Respondent has protectable trade secrets and can enforce the restrictive covenant.

For the reasons set forth above, we respectfully request that the District Court's decision be affirmed.

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I certify that, in connection with the preparation of this brief I have examined Rules 18, 19 and 39 of the United States Court of Appeals for the Ninth Circuit and that, in my opinion, the foregoing brief is in full compliance with those rules.

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